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Ten lessons to learn

The Economist; London; Dec 23, 1995; Summers, Lawrence;

Volume: 337
Issue: 7946
Start Page: 46
ISSN: 00130613
Subject Terms: Guidelines
Emerging markets
Economic recovery
Economic policy
LDCs
Economic policy
Economic depression
Economic conditions
Developing countries
Currency devaluation
Classification Codes: **9173:** *Latin America*
9150: *Guidelines*
1120: *Economic policy & planning*
Geographic Names: Mexico
Mexico

Abstract:

The Mexican crisis is not yet history. But enough time has passed, and enough reflection on it taken place - at the Halifax Summit, within the IMF and other international financial institutions, and among market participants - that some lessons can now be distilled.

Full Text:

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[Headnote]

On December 20th last year, Mexico's financial crisis began with a botched devaluation, culminating in an international bail-out plan led by the United States Treasury. For this anniversary, Lawrence Summers, deputy secretary at the Treasury and deeply involved in the bail-out, draws lessons from Mexico's troubles for other emerging countries

[Photograph]

Caption: I must not run a big deficit

THE form of Mexico's crisis was shaped by the financial innovations of recent years; and advances in information and communications technology caused it to be propagated globally in a way that is without precedent. It is little wonder, then, that the International Monetary Fund's managing director, Michel Camdessus, has labelled it as the first crisis of the 21st century.

Mexico has made great progress in the past 11 months, returning to the private capital market far more rapidly than most observers expected. This is a tribute to the sound policies that its leaders have adopted and to the rapid and substantial international support it has received. While recent turbulence reminds us that Mexican economic recovery will take time, the critical phase has passed. Certainly this is true for emerging markets in general, which no longer move in tandem with events in Mexico, as they did earlier in the year.

The Mexican crisis is not yet history. But enough time has passed, and enough reflection on it taken place-at the Halifax Summit, within the IMF and other international financial institutions, and among

market participants that some lessons can now be distilled.

Obvious, but easily forgotten

The first is plain and simple: sound policies are absolutely essential. One of the most foolish things said about the international economy these days is that because capital moves so quickly and so freely, government policies have little influence. In reality, precisely because of greatly increased capital mobility, the difference between having the right and the wrong government policies has never been greater.

Twenty-five years ago it was almost inconceivable that many countries might grow at 7%, 8% or 9% a year, year after year. Yet in some places such growth rates have now become almost commonplace. Open economies have learnt that they can attract enough capital to make this possible by pursuing sound policies that ensure both that there are profitable opportunities for investors and that they are able to take them. And just as good policies are rewarded more richly than before, mistaken policies are punished more severely. Countries have in the past made the mistake of pursuing ultimately incompatible monetary and exchange-rate policies, as Mexico did last year. Rarely, if ever, have they been brought to grief as quickly as was Mexico.

That is because of a second lesson: that unsustainable policies cannot be sustained. This is a cliché, and tautological to boot; but it is nonetheless important. Economic historians can debate whether, with a tighter monetary policy implemented early enough in 1994, Mexico could have sustained its exchange-rate regime. What is clear is that the particular combination of Mexican monetary and exchange-rate policies was not sound. These policies were certain to collide, sooner or later.

Mexico's experience points up a broader issue. There is a natural human tendency, magnified by the political process in every country, to regard good news as permanent and bad news as temporary. When capital flows taper off, the temptation for government officials is to dip into reserves, sterilizing their intervention to avoid a contractionary effect on monetary policy. On the other hand, good news is often treated as permanent and an excuse for big spending programmes.

The reality is that capital inflows are often a reflection of transitory changes in the international environment, while outflows are usually a sign of an enduring problem. Hence a third lesson: emerging-market governments should treat capital outflows as permanent, allowing themselves to be pleasantly surprised if they turn out not to be.

A fourth lesson with longer-term implications is that, even with the increasing sophistication of international capital markets, high rates of domestic savings are essential for healthy development. The difference between Latin American and Asian economic experience over the past several decades brings this out clearly. In Asia, where savings rates are high, discussion of growth starts at 5%. In Latin America, where savings are low, growth aspirations are low too. Chile is the one country in Latin America with an Asian saving rate; it is also the one Latin country that has achieved an Asian growth rate.

It is all very well for critics with the benefit of hindsight to argue that Mexico was asking for trouble by running, in 1994, a current-account deficit of 8% of GDP. For if Mexico had chosen not to permit such a large current-account deficit, and still maintained the same low level of domestic savings (an estimated 14%), it would not have had the finance to maintain investment at even its relatively modest estimated rate of 21% of GDP. That would have meant it was failing to lay deep enough foundations

for future growth.

As the Mexican authorities have now recognised, though, if Mexico is to grow at a reasonable rate without returning to dependence on an unsustainable current-account deficit, it must put in place longer-term measures to increase domestic savings. These include reducing the rate of inflation so that savers are more certain that they will get positive real returns; reforming the pension system; maintaining fiscal discipline; and working to ensure that a well-functioning financial system provides adequate returns even to small savers.

Foreign finance certainly cannot be relied upon. Nigel Lawson famously asserted that current-account deficits are not dangerous so long as they are not caused by government budget deficits. He was certainly correct to imply that current-account deficits caused by budget deficits are a serious problem. However, as Mexico's experience reveals all too clearly, even current-account deficits that arise alongside a sound fiscal policy can cause serious difficulties. Policy-makers should remember that current-account deficits, however caused, represent borrowing on a national scale. They are dangerous if they are too big; or if the terms on which they are financed are too sweet for the creditor; or if the proceeds are not used to generate extra capacity to repay.

These principles and the Mexican experience suggest a fifth lesson: that close attention should be paid to any current-account deficit in excess of 5% of GDP, particularly if it is financed in a way that could lead to rapid reversals. A current-account deficit in which the financing is made possible by government guarantees to creditors, such as happened through the currency-risk insurance provided by Mexico's dollar-denominated tesobonos, or through deposit insurance on foreign deposits in domestic banks, should also be watched carefully. Particular scrutiny is needed if increases in capital inflows are not matched by increases in investment in traded-goods sectors.

It is, of course, easier to condemn excessive current-account deficits than to prescribe what countries facing large inflows of short-term capital should do. Working to raise domestic savings rates is an important first step. Avoiding measures that explicitly or implicitly provide government guarantees is another. In cases where these measures do not work, government should be ready to accumulate reserves. As Mexico found out, reserve levels that look very substantial can dwindle quickly.

Transparent for all to see

A sixth lesson may be harder for developing-country governments to accept: the need for greater openness. Transparency is essential to a well-functioning international capital market. Just as the idea of GAAP (generally accepted accounting principles), has made an enormous contribution to American capital markets, so standards for reporting and disclosure can make an enormous contribution to the international capital market. In today's securitised world, such standards are especially important.

Full disclosure will attract capital by reassuring the investment community. Moreover, it will promote market discipline, generating a faster response from private analysts and public institutions when trouble looms on the horizon. Most important, the discipline of disclosure fights policymakers' temptation to believe that they can somehow slip and slide their way through problems by making use of clever reporting.

Contrary to much that has been said, figures on Mexican tesobono debt were freely, immediately and publicly available throughout 1994. And while foreign-exchange reserves figures were provided irregularly, contemporaneous market reports contained quite accurate estimates. Nonetheless, as the

Mexican authorities have recognised by putting their official statistics up on the Internet, fuller, prompter disclosure can only help. Recent steps taken by the IMF to set standards for countries' disclosure and to identify countries that meet them should make an important contribution to improving the functioning of the world capital market.

[Graph]

Caption: Via dolorosa

[Graph]

Caption: Bumpy

[Graph]

Caption: Improving

The seventh lesson, however, is that even when armed with all this extra information, the financial community must become better at surveillance. This is a task for private analysts, as well as for the IMF. But it is also a task for national finance ministries. Indeed, mutual surveillance is a central function of G7 finance ministers' meetings. Two secretaries of the Treasury, Lloyd Bentsen and Robert Rubin, have sought to spread the net through the APEC finance ministers' group, which will hold its third meeting in Japan next spring, and through a Latin American finance ministers' group that will meet for the first time next year.

The IMF'S present surveillance efforts, and indeed the analyses that go on in many of the world's finance ministries, were appropriate for the current-account-centred world of 20 years ago. They are not sufficient for today's more capital-account-centred world. Rather, to be useful today, analyses must focus more attention on the composition of capital flows, the risks of liquidity problems, and the possible reaction of capital markets to political shocks.

The style as well as the substance of surveillance exercises needs to be changed. The once-a-year cycle of sending teams of analysts to interview national officials and examine the books may have fit the rhythms of earlier eras. It is not appropriate today. Following the Mexican crisis, the IMF has announced changes in its surveillance procedures. They are a valuable first step. But even more important will be the lessons learnt by governments and the markets.

The international community must develop a greater capacity to respond to financial emergencies. The Mexican crisis reminds us of the classic banking distinction between liquidity and solvency problems. Just as a prophecy that a sound bank will fail can become self-fulfilling once a run starts, a country that is fully solvent can experience great difficulties, as prophecies of default prove to be self-fulfilling. And as bank runs have serious contagion effects on other banks, so the response of emerging markets around the world to Mexico's crisis shows that country runs can do the same.

As with domestic bank runs, any last-resort lending also raises questions of moral hazard. Planning too well to deal with **failures** may encourage countries to behave irresponsibly, and also undermine market discipline as investors rely on the international community rather than monitoring country risks. On the other hand, not planning in advance runs serious risks too. The Mexican emergency could easily have happened in a country that did not border on the United States, or at a time when the IMF was less well positioned to act.

To use an analogy, it is no doubt the case that fewer people would smoke in bed without fire departments. But this is not usually taken as a serious argument against fire departments. In the same way, the G7 leaders in Halifax were right to call-eighth lesson from Mexico-for the development of IMF emergency financing procedures, and for increasing the General Arrangement to Borrow to

support these procedures. To minimise moral hazard, however, it remains essential that these procedures should not be spelt out in detail; and that it be universally understood that any financial assistance will come only with rigorous conditionality.

In future, the international community will have to explore the possibility of orderly work-out arrangements, for situations in which debt cannot be paid. An international system for debt work-outs already exists for sovereign creditors through the Paris Club, and for bank creditors through the London Club. Such systems have worked passably well, because the number of key actors has been relatively small, so free-rider problems could be overcome. In the case of banks, regulatory suasion was a further factor supporting co-operation in working out arrangements that were mutually satisfactory for debtors and creditors.

The big gap in the international system for handling sovereign crises is securitised debt. Tens of thousands of mutual funds and bondholders have replaced bank syndicates as the dominant source of private finance to developing countries. Not only are such groups of creditors too large to identify and organise; governments have far fewer powers of suasion over them.

Bondholders were free-riders throughout the debt crisis of the 1980s. This will not be possible in the future. At a time when many emerging-market debt instruments carry yield spreads of 500 or even 1000 basis points above LIBOR, it is foolish to suppose that there will never again be a default. While it is essential that nothing be done to license any country's decision not to meet its obligations (so no Chapter 11 for countries!), it is hard to believe that some planning is not needed to cope with crises that will come in the future.

In Halifax, G7 leaders called for study of this difficult issue. Any possible work-out procedure is bound to have problems. But it should be remembered that the present non-system is hardly satisfactory.

Invest for the future

In the end, however, fundamental solutions must always begin at home. The basic one, which is a ninth lesson, is that long-term investment must be promoted. There are two important differences in the nature of capital flows to Asia and Latin America. One is Asia's lesser need for capital flows, as a result of its higher savings rate. The second involves the fraction of capital flows that take the form of direct investment. Direct investment flows are higher quality because they usually represent a longer-term, better-informed commitment to an economy. The quality of capital flows can be as important as the quantity.

Latin America needs an estimated \$60 billion per year to pay for infrastructure investment. Asia almost certainly requires at least \$200 billion a year to the end of the century. International financial institutions such as the **World Bank** should accept that their role is to support, not supplant private finance. They can improve the quality of capital flows by enhancing their use of guarantees to catalyse longer-term investments. In particular, the institutions could guarantee (with government cross-guarantees) the political risks associated with long-term investment projects. For example, they could insure power-plant firms against punitive future regulation of electricity prices, thus eliminating one of the biggest disincentives to such investment.

[Photograph]

Caption: Happy but poor

Even so, there is a tenth lesson: that there can be no substitute for continuing the work of economic

integration if the momentum of reform in the developing world is to continue. There are people who interpret Mexico's difficulties as showing that NAFTA was a mistake for the United States. The opposite is the case. The argument for NAFTA is that people are continuing to live on America's border in a society that was and is moving ever more firmly towards democratic capitalism. NAFTA has locked in that trend, making it irreversible even when it was most sorely tested.

There is nothing going on in the world today that is as hopeful for humanity as the trend towards market institutions in the developing world. It will be tested by more financial crises in the future. Countries will have to export their way out of financial difficulties. If the momentum of marketdriven growth is to be maintained, it is important that the march towards lower trade barriers-unilaterally, regionally and multilaterally-continues.

None of these ten lessons represents a radical departure from past knowledge. In detail, Mexico's crisis may have seemed to belong to the 21st century. In basic substance, it points out eternal verities of finance. Because of what Mexico has done, and what the international community has done, the Mexican crisis does not look like one that will figure prominently in history books written 50 years from now. Nonetheless, there is much that can be learnt from it. And if those lessons are learnt, they should enable the history books to tell a happier story than they would otherwise.

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